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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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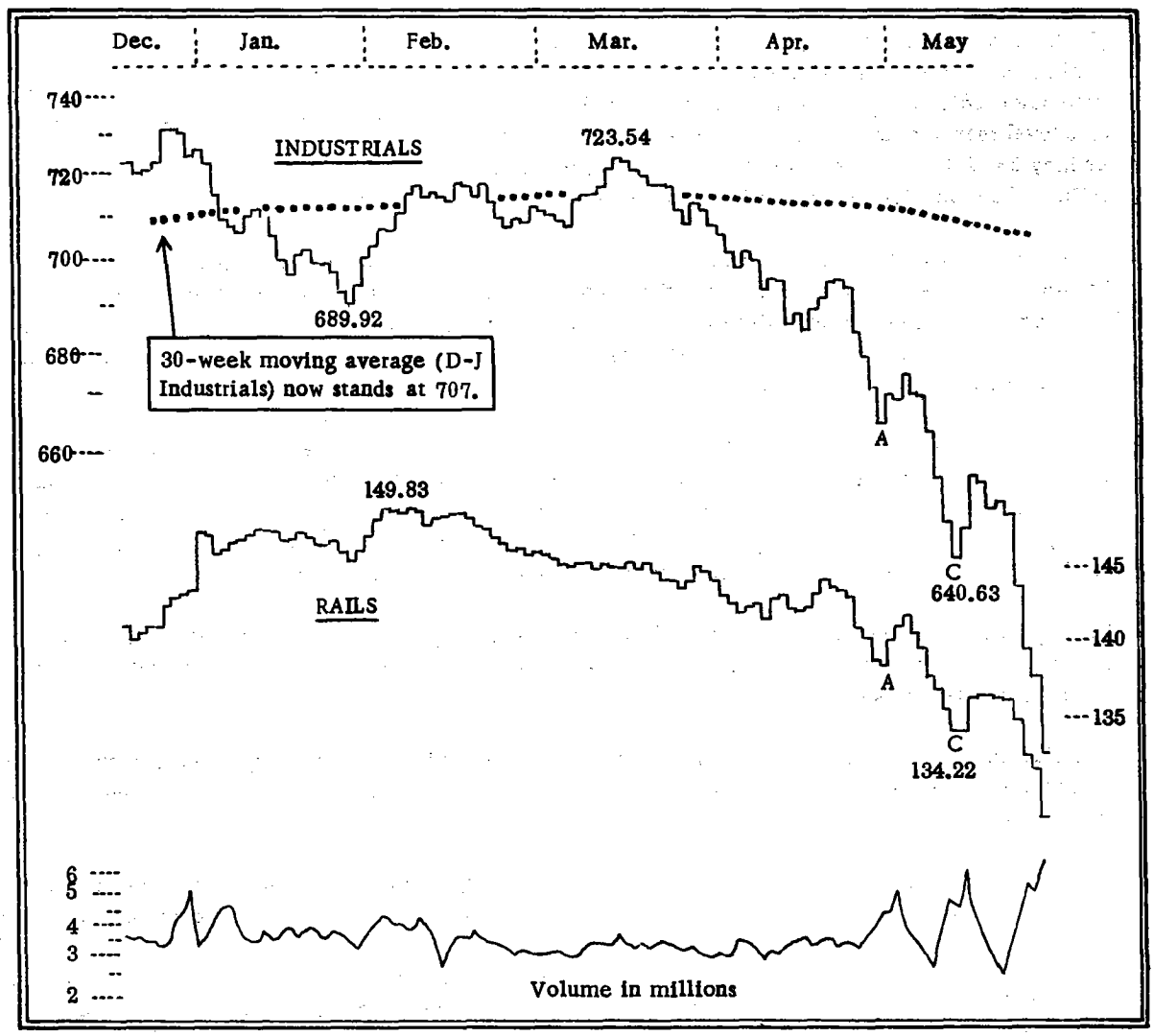
THE MARKET Applying standard measurements to the market of the past few weeks was like trying to weigh a Grizley Bear with a postage scale. Odd-lot shorts sky-rocketed, total declines on a ten-day basis were staggering, new lows boomed to breath-taking proportions, all the technical indications that would normally have called for a "bottom" any time over the last thirteen years were washed away like so much chaff in the wind.

In Letter 180 I wrote: "Those who pretend to 'see' support levels for the Averages, if other bear markets are any criterion, are 'whistling in the dark'. During a primary bear swing the market stops at levels of its own making."

Last week saw the Industrial Average smash through the 640, 630 and 625 "support levels." Indeed, the market acted as if those levels never existed.

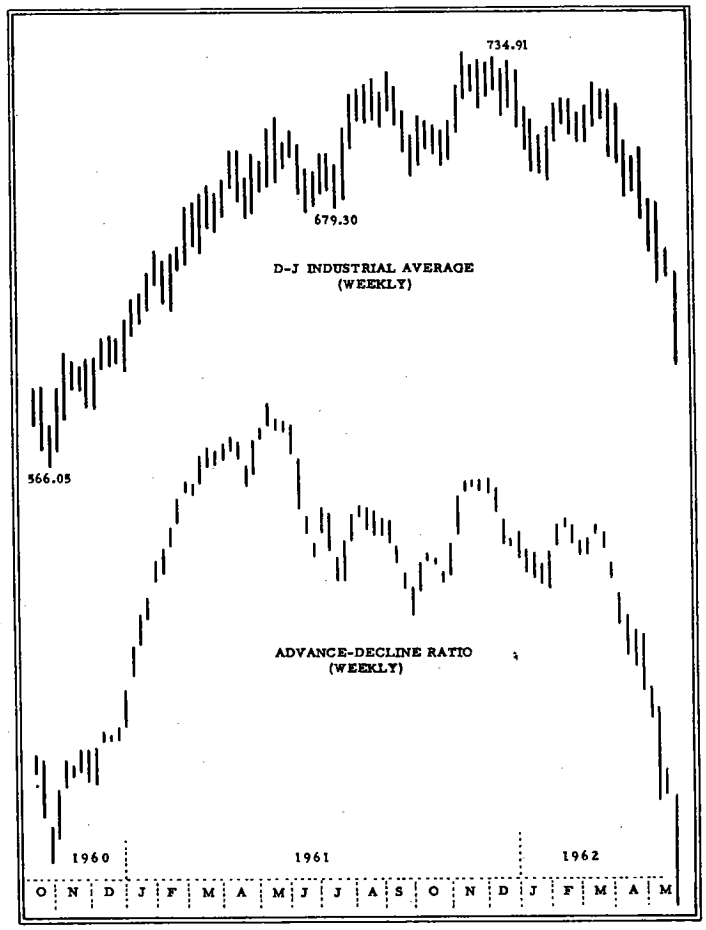
When a market develops this much of "a head of steam", it is almost fruitless to pick apart the daily action. Only three times in recent history has a market behaved with this much downside violence -- 1937, 1938 and 1946. Each of those declines saw at least one day of panic-type action (we have not yet seen this); each of those collapses was followed by a rise which was less than impressive.



In the next section I have attempted to outline a few of the implications of the larger picture (as against the vagueries of possible short-term fluctations).

EXTRAORDINARY TECHNICAL PHENOMENON On May 23, the advance-decline ratio (representative of the advancing and declining tendencies of all N. Y. Stock Exchange issues) broke below its October, 1960 low (see weekly

chart on page 2). This means that this important indicator has now more than wiped out its entire 1960-1961 advance. It is a rare occurrence when the A-D ratio erases an entire preceding advance. In fact, referring to charts going back to 1926, the last instance of comparable action occurred in the 1929-30 period.



A review of that period might prove worthwhile. From a low of 198.69 in November, 1929, the Industrial Average rose to 294.07 in 1930. Following the rise, the Industrial Average and the A-D ratio started down again. In June, 1930 the A-D ratio broke below its November, 1929 low, but Industrials halted at 211.84 (13 points above the November, 1929 low). This non-confirmation set off a rally which took the Industrials to 245 in September, 1930. Following the three-month rally, Industrials turned down and plunged below the November, 1929 low of 198.69 -- thus confirming the low recorded by the A-D ratio. By the end of the year Industrials had sunk to 160.16.

Nobody can know for certain whether history is fated to repeat. The odds are always against market action of the 1929-32 variety. Nevertheless, technical patterns (with variations) do repeat. The recent action of the Industrial Average and the advance-decline ratio lead me to believe that one of the following two possibilities must be considered:

(1) In order to confirm or "get in gear" with the advance-decline ratio, the Industrial Average would now have to drop below 566.05, the comparable October, 1960 level (the level that was penetrated by the advance-decline ratio on May 23, 1962). There is a chance that with only minor rallies, the Industrial Average could break below the 566.05 level from this area.

(2) The other possibility is that we could now get a rally comparable to the June-September, 1930 advance. Since the Industrial Average has not yet confirmed the downside penetration of the advance-decline ratio, a technical rally of the 1930 variety could now occur. However, this writer is of the opinion that (despite rallies) the odds favor a final confirmation of the advance-decline ratio by Industrials. In other words, technical considerations suggest that the Industrials will eventually go below 566.05.

One other point should be mentioned. During the rally of April to September, 1930, the advance-decline ratio literally moved sideways while the Industrial Average climbed from 211 to 245. This means that the bulls had a very difficult time of it, that the market was viciously selective, and that the average investor who attempted to "scalp" the bear market (by buying into the rally) probably lost money. I continue to believe that the best place for money during a major bear market is in the savings account of a large commerical bank or in short-term U.S. Treasury Bills.

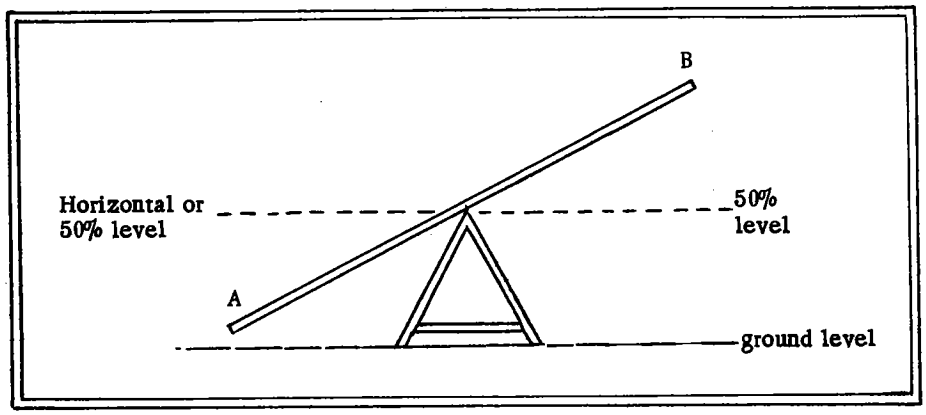
50% PRINCIPLE Many subscribers have asked for a detailed explanation of the 50% Principle. Since I regard this concept as a very fundamental one, I believe readers should understand the theory behind it. The 50% Principle is actually based on easily understood laws of physics.

The diagram (page 3) illustrates a child's see-saw (a fulcrum and beam in physics). Consider that the right side of the beam (point B) represents the Industrial Average. When B moves up the Average is rising; when B goes down the Average is declining.

At the beginning of a rise we will find B in a position on the ground level. As the advance progresses, B swing higher, and towards the end of the advance B will be far above the ground (in the exact position pictured on the diagram).

Now, a correction of the advance begins. As the correction continues, B declines towards the horizontal or 50% level. It is here that the 50% Principle is put to the test. If, on the decline, point B holds at or above the horizontal (or 50%) level, we can consider that the upward momentum is still in effect. The beam will then rise, and B will swing towards

the highs once more.



On the other hand, if the downside momentum of the decline is such that point B is forced below the 50% level, we can then consider that the primary upward momentum has terminated. When this happens, B will swing well below the 50% level, and the chances are that in due time B will approach or touch the ground again.

One point should be mentioned. The longer (in both duration and extent) the preceding movement, the more valid is the 50% Principle. In other words, the Principle becomes rather meaningless when used in connection with a two day rally of 15 point or so. It becomes very meaningful when measuring a major advance of 150 to 200 points extending over a period of a year or two.

HOPES Last Sunday the Los Angeles Times's business section was ablaze with the headline: "Must Stocks and Business Move Hand-in Hand?" A sub-title added hopefully: "Business Continues to be Good Despite Sagging Market." This brand of optimism is fairly representative of sentiment throughout the country at this time. I urge readers to dismiss it as the sheerest form of wishful thinking. When the stock market deflates itself, the rest of the nation will not be far behind. Let it not be forgotten that the action of the market represents the sum total of what the best minds and the biggest money see ahead for the nation's business.

Since January of this year the value of securities listed on the New York Stock Exchange alone has dropped about 70 billions of dollars. As a meaningful comparison, total U. S. corporate profits and inventory valuation adjustments for the year 1961 were 45 billions (see World Almanac). The drop since January is no minor adjustment, no mistake, no mere revision of confidence. It is a warning today which will apply to conditions tomorrow.

FOREIGN MARKETS In the last Letter I warned readers against trying to "outguess" the Averages. The thought was expressed that the market action of the past few months is discounting unfavorable factors, factors that may have little or nothing to do with the "Kennedy--confidence" idea which has been put forth by so many newspapers and periodicals.

Bull and bear markets (and most extended secondaries) tend to be international in scope. If America is in trouble, the Free World is in trouble. If the Common Market countries encounter adversities, this country will share in those adversities. If the gold problem is pressing here, the currencies of other countries are sure to be affected.

The stock averages of leading Free World nations (see page 4) now present an interesting study. West Germany (with Europe's "wonder economy") saw its market "top out" in mid-1960. A month ago the German stock average broke below its 1961 secondary low (a bear signal). Last week England's Financial Time Average broke below its 1961 low, thereby following German's bearish example. The Italian market, having struck a high in mid-1960, has now broken below a one-year trading range. Last month the Dutch average shattered its 1961 low, thereby sinking to the lowest level since early 1960. Only the French and Belgian markets stand intact. The "box score" in Europe is bearish.

The foreign stock averages seem to be reflecting a story being told by investors everywhere. The message is not a pleasant one. Markets throughout the Free World are heading down.

STOCKS AND LATE NOTES As this Letter is concluded (2 P.M. N.Y. Time, Monday, May 28) the market is down on a late tape (over 35 minutes late). When dealing with such a whirlwind, I suggest refraining from trading. The market is now caught in the emotions of perhaps 15 million investors and traders. It can do anything, it is now beyond normal measurements. The "sidelines" becomes the proper place for a Dow Theorist is this situation. Long stocks are melting away, shorts are making money. The situation could reverse in an hour or a week . At this time there are no "answers". Only fools would hazard definitive opinions.

Of the 30 stocks which comprise the D-J Industrial Average,27 are now bearish. Only International Harvestor (48), Standard of California (52) and United Aircraft (44) still retain bullish patterns. If the numbers in parentheses are touched,

 these stocks too will turn bearish.

I do not think an important rally can materialize from this type of damage without the passage of a good deal of time. Playing technical rallies in a bear market is extremely difficult -- it is the floortraders work.

Those subscribers who heeded these Letters should now be clean of stocks. Their speculation on cash has paid off rather handsomely so far. In terms of the stock market, they are able to buy a good deal more now than they were last week or last month. Cash is in a bull trend.

APOLOGIES The last three Letters have been completed, typed and printed within a single day (due to the urgencies of the marketplace). Such haste is bound to produce spelling and typographical errors. I hope readers will be indulgent.